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AGENDA ITEM 3

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. SUBJECT:** Policy Subcommittee Report
- II. PROGRAM:** Total Fund
- III. RECOMMENDATION:**
 - a. Adoption of Policy for the Inflation-Linked Asset Class and Three of its Components: Commodities, Inflation-Linked Bonds, and Forestland
 - b. Revision of Policy on Dollar-Denominated Fixed Income Program

IV. ANALYSIS:

Background

The Policy Subcommittee met on December 14, 2007. The Subcommittee reviewed the new Inflation-Linked Asset Class policy and also examined proposed revisions to the Investment Policy on Dollar-Denominated Fixed Income Program.

The proposed Inflation-Linked Asset Class and revised Dollar-Denominated Fixed Income Program policies are attached. Unless otherwise noted, they are presented as black-lined versions from the last adopted policy by the Investment Committee. The black-line uses strike-out to indicate deletions and double underline to indicate additions. Single underline does not indicate a change; rather, it indicates that the term is defined in the glossary.

**Adoption of Inflation-Linked Asset Class and Three of its Components:
Commodities, Inflation-Linked Bonds, and Forestland (Attachment 1)**

The Policy document consists of a master ILAC Policy and individual policies for three of the four ILAC components: Commodities Program, Inflation-Linked Bond Program, and Forestland Program. An Infrastructure Program policy will be presented in early 2008.

The investment policies for the Commodities Program and Forestland Program represent revisions to existing policies. The Inflation-Linked Bond Program policy is new.

The Subcommittee reviewed the proposed Policy on the Inflation-Linked Asset Class and directed staff to make the following changes:

1. The Subcommittee recommended adding a stipulation for the Commodities Program, regarding permitted collateral investments. Inflation-linked bonds may not exceed 20% of the Commodities Program collateral. This revision has been made to page 6 of the Commodities Program attachment.
2. During the Subcommittee meeting, there was discussion centered on sustainability of forestland and quality of forestland investments. Staff recommended adding a reference to the Hazardous Materials in Real Estate Investments policy. This policy, where practical, is applied to real estate investments. The Subcommittee agreed with Staff's recommendation, and the reference has been added to page 3 of the Forestland Program attachment.
3. The Subcommittee also discussed the loan-to-value ratios for the Forestland Program. The Subcommittee Chair directed staff to clarify the leverage language and to also add a quarterly reporting requirement in which staff will report to the Investment Committee regarding loan-to-value ratios and asset allocation targets. These changes have been made to pages 7 and 10 of the Forestland Program attachment.

In addition to the recommended revisions discussed at the Subcommittee meeting, Staff recommends an additional change to the policy. On page 3 of the Inflation-Linked Asset Class Policy, the recommended range for the Inflation-Linked Asset Class was 2-7%; however, the range approved by the Investment Committee was 0-5%. This change has been made.

Wilshire's opinion letter which supports the staff recommendation is included as Attachment 2.

The Subcommittee recommends approval of the Staff recommendation, with changes requested at the Subcommittee meeting. The requested Subcommittee changes are shown in black-line and highlighted in gray.

Revision of Policy on Dollar-Denominated Fixed Income Program
(Attachment 3)

Recently, the Investment Committee approved expanding the internally managed dollar-denominated fixed income program to include shorting and to increase limits for non-investment grade securities in order to enhance the return of the program. Revisions to sections VI.C.2 and IX.A of the policy incorporate approved shorting guidelines and limits for non-investment grade securities.

The revisions also include the following technical changes:

1. Inclusion of the Foreign Debt Policy as an attachment to this policy.
2. Consistent differentiation between investment grade and non-investment grade securities. Previous versions of this policy did not consistently separate investment and non-investment grade securities for every sector. The proposed language creates a consistent definition and clarifies the difference between investment grade and non-investment grade securities.

In addition to the changes proposed at the Subcommittee meeting, Staff recommends an additional change to the policy (in Section IX.A.1). The policy incorrectly stated, "short selling of securities is allowed with restrictions." Staff's intent was to list permitted areas of short selling of securities. This error has been amended.

The Subcommittee recommends approval of the Staff recommendation as presented. The additional revision is shown in black-line and highlighted in gray.

Proposed Revision of 2008 Meeting Dates (Attachment 4)

In the past, the Policy Subcommittee has met bi-monthly on the Fridays preceding the Investment Committee meetings. The new Policy Subcommittee meeting schedule, which is on Mondays, is included as Attachment 4.

V. STRATEGIC PLAN:

This item supports Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

The results of this item will provide CalPERS with enhanced efficiencies and ability to manage the overall portfolio. The revised policies will provide a foundation for compliance, accountability, and transparency.

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Division Chief

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